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From: Greg Sidak
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Subject: UNE-P and the Cost of Equity: Does TELRIC Pricing IncreaseILEC Risk?

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J. GREGORY SIDAK
American Enterprise Institute (AEI) - General
ALLAN T. INGRAHAM
Criterion Auctions, L.L.C.

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The Telecommunications Act of 1996 sought to improve competition through facilities-based investment. Thomas Jorde, Gregory Sidak, and David Teece hypothesized in 1999 that mandatory unbundling at TELRIC (total element long-run incremental cost) prices would increase the equity costs of incumbent local exchange carriers (ILECs) and reduce their investment incentives by subjecting them to increased risk during economic recession. In particular, competitive local exchange carriers (CLECs) are more likely to lease unbundled network elements (UNEs) when demand for telecommunications services is weak, because low prices for those services cannot support the high sunk costs of facilities-based investment in the short-term. Alternatively, when demand for telecommunications services is strong, higher prices for those services will afford a CLEC additional revenue to build out its network. Because TELRIC prices are not compensatory in economic terms, ILEC returns will suffer in times of recession and improve during an expansion.
We empirically test the Jorde-Sidak-Teece hypothesis. We find that the ILECs' betas increased positively and statistically during the recession that began in March 2001. Consequently, their equity costs rose by between 0.4 percentage points and 4.1 percentage points, which reduced their incentives to invest in their own networks. This result is consistent with the Jorde-Sidak-Teece hypothesis.

Recent stock market events also appear consistent with the Jorde-Sidak-Teece hypothesis. On January 6, 2003, a front-page story in the Wall Street Journal speculated that the FCC would revise its rules on mandatory unbundling at TELRIC prices in a manner that would benefit the ILECs. Specifically, the report implied that CLECs would lose the opportunity to lease all network elements as an "unbundled network element platform," better known as UNE-P. The report was significant because UNE-P had become an entry strategy for CLECs that rested on regulatory arbitrage: UNE-P is functionally equivalent to resale, yet it is more favorably priced for the CLECs than is resale. The practical effect of ending the pricing arbitrage created by UNE-P would be to force CLECs to pay resale prices or resort to an entire or partial facilities-based business model for providing local telephony. Put differently, UNE-P would not disappear; it would simply be priced by arms-length negotiation between ILECs and CLECs rather than by a regulatory commission.

The abnormal returns of telecommunications equipment manufacturers on January 6, 2003 are highly probative of whether mandatory unbundling at TELRIC prices - epitomized in its most extreme form by UNE-P - is thought by the capital markets to increase or decrease investment in the network infrastructure required for local telephony. We find that the positive returns for the telecommunications equipment manufacturers exceeded by approximately 5 percent the return that the market could explain. If mandatory unbundling of network elements at TELRIC prices actually encouraged investment in local telecommunications infrastructure, then the abnormal returns to the telecommunications equipment manufacturers would have been negative on January 6, 2003. Instead, the positive abnormal returns to JDS Uniphase, Lucent, Nortel, and Tellabs reflected an expectation of the capital markets that these firms would have increased net cash flows, which would result from greater (not lesser) sales of telecommunications equipment.

J. Gregory Sidak
F.K.Weyerhaeuser Fellow in Law and Economics Emeritus

American Enterprise Institute
1150 Seventeenth Street, N.W.
Washington, D.C. 20036
United States of America
(202) 862-5892 phone
(202) 862-7177 fax
jgsidak@aei.org or jgsidak@aol.com

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